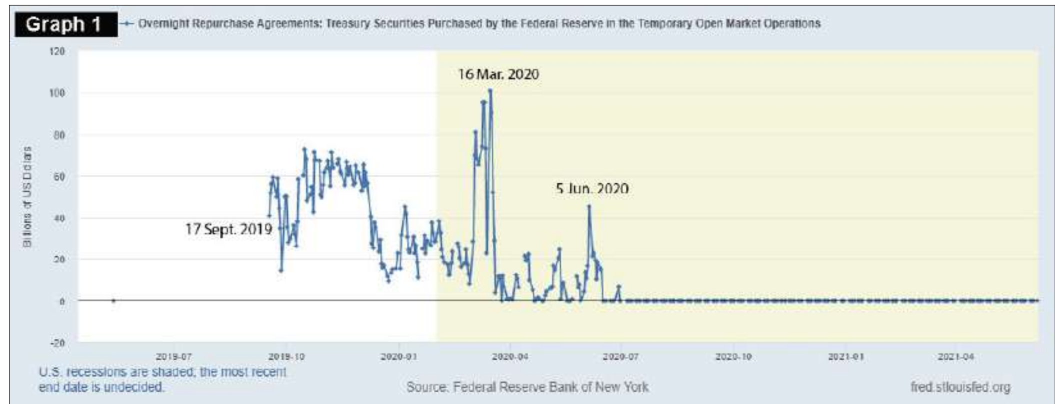
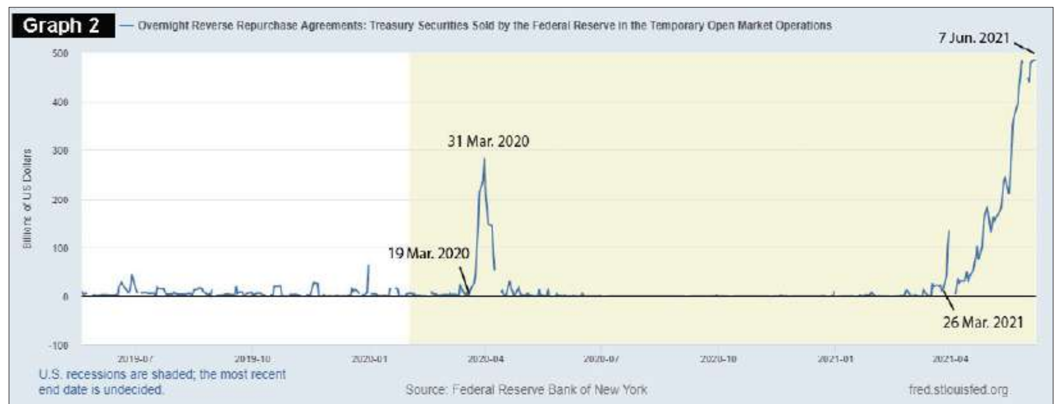
Does extreme Fed juggling act signal the end is nigh?

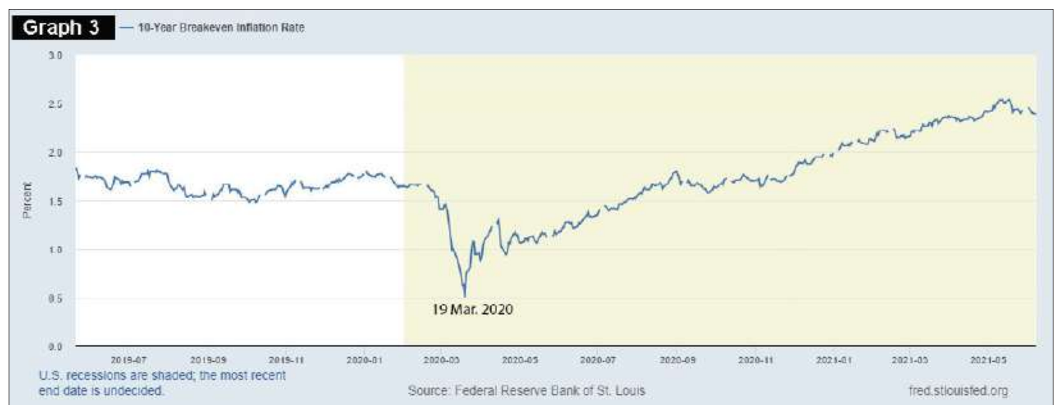
By Elisa Barwick

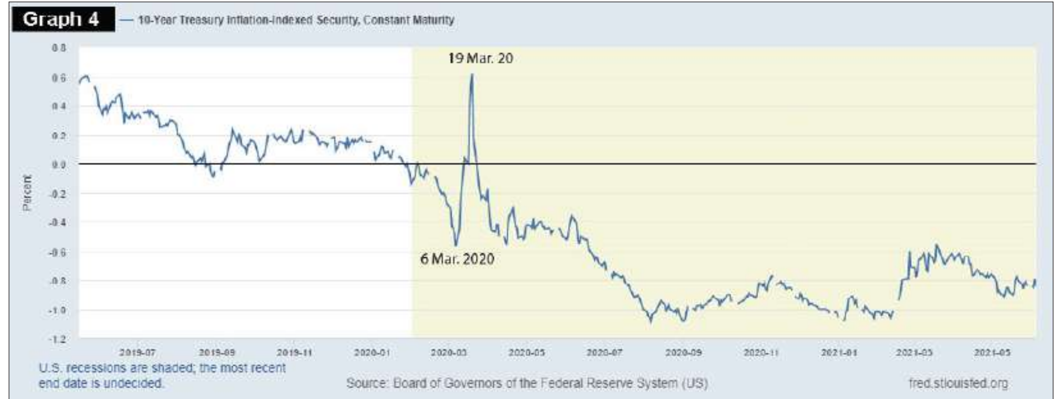
Since the 2008 global financial crisis we have been living on borrowed time, leveraging and looting, betting on, bundling and reselling anything that moves, flogging off the family silver, and even flat-out printing money to keep a broken system from collapsing entirely. Numerous warning signs since September 2019, indicating that the ticking time bomb was about to blow, were met with the same approach. A crunch point is now looming where the inevitable cannot be delayed any longer.

Central bank injections over the last 13 years have inflated asset bubbles, but inflation is now hitting the real economy too. The impact of inflation fears is clashing with the commitment to keep propping up banks and asset prices, wedging the US Federal Reserve into a corner and creating a new flash point, reflected in the accompanying graphs.









In the infamous "repo" crisis of September 2019, overnight lending between banks and other funds, which ensures access to liquidity for the next day's business, went haywire. The Fed had to step in with "repurchase agreements" to increase liquidity by lending to banks overnight against collateral that they agree to repurchase the next day. **Graph 1** shows the commencement of such operations in 2019 and the following spike in March 2020. But the Fed is now conducting "reverse repos" in record volumes (**Graph 2**), which makes use of the same mechanism, only in the opposite direction. The Fed sells Treasury securities to banks and other agencies, taking cash off their hands. A review of the timeline, beginning September 2019, reveals that the Fed has boxed itself in between both extremes, and there is no getting out without a complete redesign of the whole system.

The Fed's drastic September 2019 intervention amounted to a bailout of hedge funds (that specialise in high-risk derivatives gambling), which were unable to access sufficient liquidity, and of the banks that refused to lend to them. At the time, a wave of hedge fund shutdowns and

withdrawal freezes was going on and the Bank for International Settlements (BIS) later reported they were demanding much more cash than usual in the form of repos. That episode set in motion a new phase in the evolution of bank bailouts, including suggestions that the Fed might lend directly to hedge funds; establish a standing repurchase-agreement facility, meaning it would take over provision of daily liquidity allowing banks to speculate with reserves they would usually lend; and provide intra-day liquidity, i.e. more regular than once-daily repo interventions, which commenced in March 2020.

Here's how it happened

On 9 March 2020 repo injections were again cranked up, amounting to a much larger bailout than the previous September (**Graph 1**). Instability was again led by hedge funds, which were losing out on their bets on the spread between Treasury yields and Treasury futures, and scrounging for short-term cash to make margin calls in an already panicked financial environment.

As seen in **Graph 3**, market expectations of inflation expressed in relation to 10-year bonds began to rise from 19 March. This dynamic is confirmed by **Graph 4**, which shows real treasury bond yields, that is the yield minus the inflation rate, soaring to a pinnacle on 19 March before collapsing as inflation began to cut into yields. On 27 March 2020, Congress passed the COVID-19 stimulus bill (*Coronavirus Aid, Relief, and Economic Security Act*) which fed into inflation fears. **Graph 2** shows the Fed dramatically reversed course around 19 March, turning suddenly from its record repo lending to reverse repo operations, which reached a peak on 31 March. This meant that banks (sometimes via intermediaries such as money market funds) were lending to the Fed (instead of the other way around) at zero per cent interest rates.

Reverse repos began a new, unprecedented surge one year later, starting in mid to late March 2021, taking off in May and continuing to rise, reaching US$486 billion on 7 June, up from nothing in March (**Graph 2**). On 10 March 2021, Congress had passed President Biden's US$1.9 trillion stimulus bill, sparking further inflationary concern. The role of hedge funds is again central, with this latest episode following the Archegos hedge fund blowout of 26 March—the same date the reverse repos began to take off vertically. The Fed also increased the number of approved repo counterparts, with additions including investment behemoth Vanguard Group, as well as increasing transaction limits.

The Fed appears to be reversing its money pumping when inflation fears soar, temporarily sopping up the glut of money it has created. Its ongoing monetary injections are threatening the once unassailable safe haven of US Treasuries as their yields are eroded by inflation, and as many financial experts contend, including US fund manager Stanley Druckenmiller, even threatening the primacy of the US dollar as a global reserve currency. If Treasury rates rise according to market expectations, the US government would spend 30 per cent of GDP each year just paying interest on this debt, Druckenmiller warned. Yet in late February 2020, the Fed had indicated it was prepared to maintain zero interest rates and conduct quantitative easing (QE) without end, *even after inflation targets are met*. This is because it is engaged in a dangerous balancing act in which even the mention of withdrawing money can trigger panic. As *Wolf Street* explained on 20 March 2021, the Fed, still engaged in US$120 billion in monthly QE, is giving with one hand and taking away with the other. Even the reverse repo option has its inflation risks, because the Fed issues more Treasuries as collateral for the agreements, which can put upward pressure on long-term Treasury rates.

All of this is further proof that monetary deck-chair shuffling has absolutely no connection to the real economy. According to analysis by *Executive Intelligence Review*, Fed flow-of-funds reports for the week ended 12 May shows the entire US banking system has a 10 per cent surplus of deposits over all bank credit, and a 70 per cent surplus of deposits over bank loans. Why are they not lending? Bloomberg's Brian Chappatta reported 29 May that they "can't make enough loans relative to deposits" and don't want to keep extra reserves as that requires them to increase capital holdings. But investing it all at zero per cent interest (and sometimes negative) in exchange for Treasuries, when other options are available, raises the question: what are they afraid of out there in the broader market?

A saner pathway

While Bank of England chief economist Andy Haldane, at least, has controversially said it's time to "turn off the tap" of monetary easing, warning inflation is to be avoided "like the plague", China has a far more effective approach. It sees through the binary approaches of QE or austerity, to a third pathway of directed credit creation, investing in the real economy to avoid inflation. For some time China has used its regulatory agencies to discourage speculation and encourage productive activity, and has now notched up some success combating inflation of commodities prices which is impacting production across the board.

Supply shortages and shipping issues have driven up prices, but that is only part of the story. A 27 May Bloomberg article noted the primary role of speculation, saying that Bloomberg's own economic models show "movements in commodity prices this year have been mainly driven by risk appetite, not fundamental demand or shortages of supply".

China's National Development and Reform Commission (NDRC) is cracking down on commodities speculation by metals producers and banks, including by threatening serious fines, strengthening oversight, changing tax rules and increasing transaction fees. The China Banking and Insurance Regulatory Commission (CBIRC) has requested banks unwind existing books of commodity-linked futures trades. It is also targeting commodity speculation among retail investors and implementing price-control measures for commodities through the exchanges. China increased banks' reserve ratios on 31 May, which were previously reduced to direct more credit into the economy.

If central banks continue to protect speculative bubbles by ploughing in more money, the consequences will be worse than just letting them burst. Inflation can rapidly lead to hyperinflation, such as in the case of Weimar Germany. A loaf of bread that cost around 160 marks in late 1922 was 200,000,000,000 marks by the end of the following year.

A 25 May article in the London *Financial Times*, titled "The demise of the dollar? Reserve currencies in the era of 'going big'", warned that a continuation of extreme US monetary policy could spell the end of the entire post-World War II dollar system. To protect people from the fallout, the current system must be junked and reorganised with a 100 per cent focus on finance for economic reconstruction, *before* the blowout comes.